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SENSITIVE

STATE FOR EEB/OMA (WHITTINGTON), DRL/ILCSR AND EUR/AGS
(SCHROEDER)
LABOR FOR ILAB (BRUMFIELD)
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SUBJECT: MISSION GERMANY'S RESPONSE TO INFO REQUEST IN
ADVANCE OF G-20 MEETINGS

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¶1. SUMMARY. (SBU) Due to the deepening financial and economic crises, Germany is experiencing its worst recession since World War II. Its export-oriented manufacturing sector, including the automotive industry, has been hit particularly hard; new car orders fell 20 percent in the fourth quarter of
¶2008. To mitigate the effects of the recession, the German government has launched two stimulus packages totaling 81 billion euros. It is also taking steps to encourage firms to retain workers and to assist the unemployed. The German government created a 500 billion euro bank rescue fund to aid banks struggling under the weight of toxic assets. It is less enthusiastic about bailing out other countries, and instead supports extending help via international institutions. At the G-20 Summit in London, Germany will support tougher regulation, a greater role for the International Monetary Fund and Financial Stability Forum, a strong signal against protectionism, and other priorities as articulated at the February 22 "Mini Summit" in Berlin. Chancellor Merkel will also promote her idea for a new Charter for Sustainable Economic Activity. END SUMMARY.

STIMULUS

¶2. (SBU) Since late 2008, Germany has passed two stimulus bills totaling 81 billion euros over two years, according to government figures. The two packages amount to 1.4 percent of GDP annually. The first stimulus plan was approved in December 2008 and amounts to around 31 billion euros over two years, of which about 12 billion euros is new spending. It consists of 15 modest measures focusing on lending to SMEs, tax breaks for fuel efficient cars, and other CO2 reduction measures.

¶3. (SBU) The second, more robust stimulus package was approved in February 2009, and amounts to 50 billion euros over two years. (NOTE: It is still unclear how much of this total represents expenditures already in the pipeline.) The

package includes 18 billion euros of investments in infrastructure, schools, hospitals and broadband technology. Measures to boost demand for cars -- such as a rebate scheme that encourages drivers to scrap vehicles older than nine years in exchange for a 2,500-euro voucher to buy newer, more efficient models -- total 1.5 billion euros. Other initiatives include lowering health insurance contributions, paying half of short-time workers' social security contributions, more training for unemployed workers, and raising child support for families on unemployment benefits. Overall tax relief measures amount to 2.9 billion euros in 2009 and 6.05 billion euros in 2010. A separate 100 billion euro "Germany Fund" has been created to help firms survive the credit crunch. Most German economists have welcomed the second stimulus package, but note its effects are not expected to show up until the second half of 2009. There are also concerns that it is too small and too heavily weighted towards investment rather than consumption.

¶4. (SBU) The stimulus and bank rescue expenditures could lead to actual new public borrowing of up to 56 billion euros in ¶2009. The Finance Ministry expects the debt-to-GDP ratio to increase from 65.5 percent to 72.5 percent of GDP by 2012. A constitutional amendment requiring states and the federal government to limit borrowing to 0.35 percent of GDP by 2020 is making its way through the legislative process. Exceptions would be allowed for natural disasters and recessions.

FINANCIAL SECTOR

¶5. (SBU) With exposure to risky assets in Iceland, Ireland, Spain, and the UK, not to mention central and eastern

European (CEE) banks, the German financial sector is struggling under the weight of toxic assets. In response, the German government created a 500 billion euro financial sector rescue fund (known as "Soffin") in October 2008. The fund consists of 400 billion euros in public credit guarantees and 80 billion euros for recapitalization -- the 20 billion euro balance is a budget line item for defaulting credit guarantees. Thanks to strict conditions for participation, many banks were initially reluctant to tap into Soffin.

¶6. (SBU) Since January 2009, more institutions have taken advantage of the fund. The list includes state banks ("Landesbanken") WestLB, BayernLB, and HSH Nordbank, which have benefitted from Soffin credit guarantees. The German states (Laender) have also provided these banks with recapitalization funds. Another state bank, SaxonLB, steered clear of Soffin assistance by merging with LBBW (the state bank of Baden-Wuerttemberg), though the state of Saxony had to assume losses relating to the merged banks. The first victim of the current financial crisis, IKB, received a bailout from the federal government and the government development bank, KfW, prior to the creation of Soffin. Commerzbank, Germany's second largest lender, received both public credit guarantees and recapitalization funds from the federal government; the government now has a 25 percent stake in the bank. Its CEO Martin Blessing recently declined to rule out that additional funds might later be needed.

¶7. (SBU) The highest profile bank bailout in Germany is that of Hypo Real Estate (HRE), called "Germany's Lehman Brothers" thanks to its systemic importance to the German covered bond ("Pfandbrief") market. To date, HRE has received over 100 billion euros in public and private capital injections and guarantees. Following inconclusive negotiations with U.S. private equity firm JC Flowers, which leads a group of investors owning almost 25 percent of HRE, Chancellor Merkel's (Christian Democratic Union) CDU) cabinet approved a draft law that would give the federal government the right to seize private property for the first time since World War

II. The draft law's expropriation clause is designed specifically for a takeover of HRE, however, and would expire in June 2009. It could be invoked only as a last resort. Unless a deal with JC Flowers is reached in the meantime, the bill could become law by early April.

¶8. (SBU) The government has so far resisted pressures from within the financial sector to create a single bad bank. Both Finance Minister Peer Steinbrueck (Social Democratic Party) SPD) and Chancellor Merkel have rejected such an approach on grounds of moral hazard and incalculable risks for the federal budget. The influential Association of German Savings Banks ("Sparkassen"), whose members have little or no exposure to troubled assets, also opposes the creation of a bad bank. Discussions have mainly focused on allowing individual lenders to set up their own bad banks to house toxic assets off their balance sheets, without shifting the burden to taxpayers. Under one proposal, Soffin would provide guarantees to individual vehicles.

REAL ECONOMY

¶9. (SBU) Germany is experiencing its worst recession since World War II. Despite GDP growth of 1.3 percent for the year as a whole, German GDP fell by 2.1 percent in the fourth quarter of 2008 and is heading downward. The Economics Ministry projects the economy will shrink by 2.25 percent in ¶2009. Deutsche Bank Research thinks a 5 percent contraction in GDP is "fairly optimistic." Exports) which fell by 7.3 percent in the 4th quarter of 2008) are the main culprit, and predicted to decline by 9 percent or more in 2009. Unemployment will increase to 8.4 percent in 2009, up from 7.8 percent in 2008, according to government estimates. Meanwhile, the German savings rate increased from 11.4 percent to 11.9 percent in the fourth quarter of 2008,

dampening hopes that lower inflation and the stimulus packages would trigger more consumer spending. A contact at the Bundesbank told EMIN that the fourth quarter of 2008 and first quarter of 2009 would be the trough of the recession, with some modest growth possible by spring 2009. This, however, seems less likely with time.

¶10. (SBU) Large industrial companies like those in the automotive, machine tool, steel and metal processing, paper, engineering, construction, shipbuilding and ceramics industries are suffering most from the slowdown, according to the Association of German Industries (BDI -- Germany's largest business lobby group). Some companies are having trouble obtaining credit or are able to do so only under less favorable terms, as banks increase loan guarantee premiums and demand tougher disclosure requirements. Many also face liquidity constraints thanks to lower revenues. Small- and medium-sized enterprises (SMEs), many of which are self-financing, had reported fewer financing troubles, but are now feeling the squeeze.

¶11. (SBU) As exports slump, the automotive industry, which employs one in seven workers in Germany, is center stage in the economic crisis. Total new car orders fell by 20 percent in the fourth quarter of 2008 to the lowest level since the late 1980s. Carmakers have cut production and terminated employment contracts for temporary workers. Both Opel, threatened by the potential insolvency of its parent General Motors, and the components supplier Schaeffler, which over-extended itself in taking over the larger Continental, say they risk bankruptcy without support from the state. While some manufacturers are attempting to protect their supply chains, 10 smaller automotive suppliers together employing almost 20,000 workers have already filed for bankruptcy. Measures in the second stimulus package to encourage new car purchases may provide some short-term relief. (See section above on stimulus.)

¶12. (SBU) Understanding the importance of trade to German industry, the German government has come out strongly against protectionism. Economics Minister Karl-Theodor zu Guttenberg remarked, "Free trade and open markets can make a considerable contribution to overcoming the economic crisis." Meanwhile, Germans are deeply concerned about "Buy America" provisions in the U.S. stimulus package and protectionist noises from major trading partner France.

SOCIAL/LABOR IMPACT

¶13. (SBU) Germany's two stimulus packages contain several measures to address rising unemployment. Most notable is the extension from 6 to 18 months of a program (known as "Kurzarbeit") whereby the Federal Employment Agency takes over a portion of social security payments from companies should they opt to introduce shorter working hours for employees instead of laying them off. The stimulus packages also include qualification and retraining programs, subsidies for firms to hire or retain temporary workers, and expansion of regional and local employment agencies. The Federal Employment Agency, which has run a budget surplus in recent years due to the previous decline in unemployment, is providing some funding in addition.

¶14. (SBU) Germany has not experienced the same level of civil unrest seen in some other European countries. In recent weeks, three major rallies have taken place in reaction to plant closures relating to the economic crisis: at Opel Qimonda, and Schaeffler. Some 15,000 Opel workers from around Germany took part in a rally on February 26 at the German headquarters of the struggling company in Ruesselsheim. They demanded that Opel's parent company General Motors scrap plans for plant closures in Europe. A demonstration involving around 3,000 workers at chipmaker Qimonda and another involving around 8000 workers at car-part supplier Schaeffler, reflect the importance of both

companies as the main employer in their respective regions.

DIMENSIONS OF THE CRISIS

¶15. (SBU) Not wanting to get stuck with the tab in an election year, German politicians are reluctant to bail out weaker European economies both inside and outside the eurozone. Germany's public finances are among the healthiest in Europe, and many Germans bristle at the thought of paying for the alleged sins of undisciplined neighbors. Under terms of the 1992 treaty leading to the creation of the euro, individual countries that use the single currency are prohibited from bailing out others if they default on their public debt. The intent of this "no bail-out" provision is to force countries to embrace fiscal discipline. Nevertheless, Finance Minister Steinbrueck has intimated Germany would not stand idly by if another eurozone member ran the risk of defaulting. His remarks reflect economic reality: 42 percent of German exports are bound for the euro region (and 64 percent for the 27 nations of the EU). A Finance Ministry spokesman denied a report in "Der Spiegel," however, that the Ministry was considering specific scenarios, such as issuance of a Eurobond, to assist weak members. A contact at the Chancellor's office confirmed that Germany opposed a common eurozone bond.
¶16. (SBU) At the March 1, 2009 EU Summit in Brussels, Chancellor Merkel articulated an emerging German approach for eurozone and non-eurozone economies alike: "We help countries in need and we will do so further, particularly through international institutions." Just a week earlier at a gathering in Berlin, Merkel and other EU leaders participating in the London G-20 Summit had called for a doubling of the IMF's balance sheet, to $500 billion, in case the fund receives more emergency requests for aid. Analysts note that this approach skirts the issue of the "no bail-out" provision, and may be easier to finesse with the German

public than unilateral assistance. Having multilateral institutions take the lead also ensures that the institutions take any political heat for imposing strict fiscal reforms on countries that accept bailouts. In return for its support, Germany will certainly want such reforms included in any multilateral bailout. Following the Brussels March 1 Summit, Merkel told reporters she hoped to get a commitment from leaders at the March 19-20, 2009 EU Summit to return to the principles of the EU Stability Pact.

ROLE OF THE G-20

¶17. (SBU) At the April 2 G-20 Summit in London, Germany will support EU positions coordinated at a February 22 "Mini Summit" in Berlin (REF B). Among the top priorities are:

-- ensuring that "all financial markets, products and participants are subject to regulation," especially those that could present a systemic risk;
-- tightening supervision of hedge funds and oversight of credit rating agencies;
-- obliging private banks to build additional capital buffers "in good times" to prepare for economic downturns;
-- designing executive compensation to prevent "excessive risk-taking";
-- strengthening the Financial Stability Forum (FSF) and International Monetary Fund (IMF);
-- creating an IMF-FSF early warning system to prevent future financial crises;
-- enlarging the FSF to embrace emerging economies;
-- establishing supervisory colleges to coordinate cross-border financial institutions;
-- taking action against tax havens and "uncooperative jurisdictions";
-- sending a strong signal against protectionism by concluding the Doha Round and ensuring stimulus measures and financial rescue plans do not distort competition; and
-- committing to fiscal discipline once the crisis has passed.

MERKEL'S INITIATIVE FOR THE LONDON SUMMIT

¶18. (SBU) In London, Chancellor Merkel is also expected to promote her idea of a new Charter for Sustainable Economic Activity (REF C). Merkel has raised the concept several times in recent weeks, including at a meeting she hosted on February 5 with the heads of five international organizations (IMF, World Bank, WTO, ILO, OECD); the IO chiefs endorsed the proposal at least on paper. Merkel also pitched the idea at the EU "Mini Summit" she hosted on February 22, appearing to get at least tacit support from her guests (REF B). (NOTE: Merkel seems to have dropped or delayed a parallel proposal for a "World Economic Council" that would parallel the UN Security Council.)

POINT OF CONTACT

¶19. (SBU) Embassy Berlin's designated point of contact on the financial crisis and G-20 Summit is Econoff John G. Robinson (email: robinsonjg@state.gov, tel.: 49-30-8305-2266).
Koenig